

**Office of Chief Counsel
Internal Revenue Service
memorandum**

Number: **201341033**

Release Date: 10/11/2013

CC:FIP:B04:GRGreen
POSTF-112068-12

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 817.00-00

date: May 16, 2013

to: Diane D. Helfgott
General Attorney (Newark, Group 2)
(Large Business & International)

from: Sheryl B. Flum
Branch Chief, Branch 4
(Financial Institutions & Products)

subject:

This Chief Counsel Advice responds to your request for assistance regarding whether § 817(a) and (b) of the Internal Revenue Code ("Code") apply with respect to variable annuities issued by Subsidiary, a nonlife insurance company taxable under § 831. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Subsidiary =

ISSUES

1. Whether § 817(a) applies to Subsidiary's separate accounts.
2. Whether § 817(b) applies to Subsidiary's separate accounts.

CONCLUSIONS

1. Section 817(a) applies to Subsidiary's separate accounts.
2. Section 817(b) applies to Subsidiary's separate accounts.

FACTS

For purposes of this memorandum, the relevant facts are as follows. Taxpayer heads a life-nonlife consolidated group that includes Subsidiary, a nonlife subsidiary of Taxpayer. Subsidiary issued variable annuities and maintains corresponding separate accounts.

For Taxpayer's 20 taxable year, Taxpayer claimed a deduction for the net realized and unrealized appreciation of Subsidiary's separate account assets. With respect to the separate account assets, Taxpayer recognized a net capital loss for realized capital gains and losses. Taxpayer did not recognize unrealized capital gains and losses.

For Taxpayer's 20 taxable year, Taxpayer claimed a deduction for the net realized and unrealized appreciation of Subsidiary's separate account assets. With respect to the separate account assets, Taxpayer recognized a net capital gain for realized capital gains and losses. Taxpayer did not recognize unrealized capital gains and losses.

Taxpayer's Position

Taxpayer's position is that § 817(a) and (b) only apply to variable annuities issued by life insurance companies, and thus do not apply Subsidiary, a nonlife insurance company. In the absence of § 817(a), Taxpayer maintains, the net appreciation, whether or not realized, in separate account assets is deductible under §§ 807(b) and 805(a)(2) because of the increase in reserves. In the absence of § 817(b), Taxpayer maintains, realized capital gains or losses are recognized, and recognition of unrealized capital gains or losses is deferred until the occurrence of a realization event.

Taxpayer argues that in the absence of § 817(a) its position is allowable under Statement of Statutory Accounting Principal ("SSAP") No. 56, applying mark-to-market accounting for separate accounts, promulgated by the National Association of Insurance Commissioners ("NAIC").

LAW AND ANALYSIS

Internal Revenue Code

Section 831(a) imposes tax on the taxable income of nonlife insurance companies. For a nonlife insurance company, taxable income means gross income minus allowable deductions. Section 832(b)(1) provides that the gross income of a nonlife insurance company as defined in § 832(b) includes its investment and underwriting income, computed on the basis of the NAIC annual statement. Section 832(b)(3) defines underwriting income as the premiums earned on insurance contracts, less losses incurred and expenses incurred.

Section 832(b)(4) defines premiums earned as gross premiums written reduced by return premiums and premiums paid for reinsurance. This amount is increased by 80 percent of the unearned premiums on outstanding business at the end of the preceding

taxable year and is decreased by 80 percent of the unearned premiums on outstanding business at the end of the current taxable year. Section 832(b)(4) (flush language) provides that for purposes of § 832(b)(4), “unearned premiums shall include life insurance reserves, as defined in section 816(b) but determined as provided in section 807.”

Section 807(a) provides that if the opening balance of the items described in § 807(c), which include life insurance reserves, exceeds the closing balance of such items, such excess is includible in gross income under § 803(a)(2). Section 807(b) provides that if the closing balance for the items exceeds the opening balance of such items, such excess is deductible under § 805(a)(2). Section 807(d) provides rules for determining life insurance reserves.

Section 817(a) applies “[f]or purposes of subsections (a) and (b) of section 807” to “any variable contract.” Section 817(a) provides that for purposes of determining the net decrease or increase in reserves under § 807(a) or (b), amounts subtracted from or added to separate account reserves by reason of the depreciation or appreciation of separate account assets, whether or not realized, are disregarded.

Applying concomitantly with the reserve adjustment rules of § 817(a) are the basis adjustment rules of § 817(b). Section 817(b) applies “[i]n the case of variable contracts.” Section 817(b) provides that the basis of each separate account asset is decreased by the amount of depreciation, or increased by the amount of appreciation, of separate account assets (whether or not realized), to the extent separate account reserves are adjusted for such depreciation or appreciation under § 817(a). The result is a permanent, company-level exclusion of capital gains tax on separate account assets.

1984 DEFRA Legislative History of Section 817

Prior to the Deficit Reduction Act of 1984 (“DEFRA”), the reserve and basis adjustment rules currently found in § 817(a) and (b) did not apply to all variable contracts. The result was the disparate treatment of different variable contracts, and in the case of certain variable contracts a mismatching of both timing and character. Congress remedied this situation in DEFRA by applying § 817(a) and (b) to all variable contracts. The version of DEFRA passed by the House applied § 817(a) to all variable contracts.

The House bill continues to provide special rules for variable annuities and contracts with reserves based on segregated asset accounts and extends those rule to variable life insurance contracts. Thus, with respect to any variable contract, the reserve items taken into account at the close of the taxable year for purposes of determining net increases or net decreases must be adjusted by subtracting any amount attributable to appreciation in value of assets or by adding any amount attributable to depreciation.

Conference Committee Report, H. Rep. No. 98-861 (DEFRA), 98th Cong., 2d Sess. 1054 (1984). The version of DEFRA passed by the Senate both accepted the House's version expanding the scope of § 817(a) to apply to all variable contracts and added § 817(b) to provide for basis adjustments for all variable contracts.

[T]he company's basis in the assets underlying all variable contracts will be adjusted for appreciation or depreciation, to the extent the reserves are so adjusted. Thus, the corporate level capital gains tax is eliminated. This basis adjustment provision generally conforms the tax treatment of all variable contracts to that of variable pension plan contracts under present law.

Id. The conference agreement applied § 817(a) and (b) to all variable contracts. Id. at 1055; see also Joint Committee on Taxation, General Explanation of the Revenue Provisions of DEFRA, JCS-41-84, 607 (1984). Consistent with the statutory language of § 817(a) and (b), the DEFRA legislative history indicates that Congress intended to subject all variable contracts to § 817(a) and (b).

Issue 1

Section 817(a) applies to any variable contract, including any variable annuity, without distinguishing between variable contracts issued by life and nonlife insurance companies. For a nonlife insurance company, § 817(a) modifies how § 807(a) and (b) apply to decreases or increases in segregated asset reserves for purposes of determining unearned premiums under § 832(b)(4). Accordingly, Taxpayer must apply § 817(a) to Subsidiary's separate account assets to determine Taxpayer's taxable income under § 831(a). For its 20 and 20 taxable years Taxpayer may not claim deductions for the net realized and unrealized appreciation of Subsidiary's separate account assets.

Taxpayer's position on its 20 and 20 returns produced a mismatching of both timing and character that Congress specifically eliminated in DEFRA. Taxpayer may argue that in DEFRA Congress only meant to address variable contracts issued by life insurance companies; however, the legislative history does not reflect any such intent, nor does the language of § 817(a).

Taxpayer maintains that in the absence of § 817(a) its return positions are allowable under SSAP No. 56, which must be used for tax purposes under § 832(b)(1). Section 832(b)(1) states that gross income as defined in § 832(b) is computed on the basis of the underwriting and investment exhibit of the NAIC annual statement. Section 1.832-4(a)(2) of the Income Tax Regulations provides that "[t]he underwriting and investment exhibit is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Code."

Section 817(a) must be applied. In light of the application of § 817(a), mark-to-market accounting for separate accounts under SSAP No. 56 is inconsistent with § 817(a) and cannot be applied. See Rev. Rul. 61-167, 1961-2 C.B. 130; Rev. Rul. 60-306, 1960-2 C.B. 211; see also Minnesota Lawyers Mutual Ins. Co. v. Commissioner, 285 F.3d 1086, 1092 (8th Cir. 2002); Home Group Inc. v. Commissioner, 875 F.2d 377, 381-382 (2d Cir. 1989); Western Casualty & Surety Co. v. Commissioner, 571 F.2d 514, 517-518 (10th Cir. 1978). Accordingly, Taxpayer cannot take the return positions claimed based on SSAP No. 56.

Issue 2

Section 817(b) applies in the case of variable contracts, including variable annuities, without distinguishing between variable contracts issued by life and nonlife insurance companies. Section 817(b) cross-references the reserve adjustment rules of § 817(a). Accordingly, to the extent Taxpayer must apply § 817(a) to Subsidiary's separate accounts, as discussed above, Taxpayer may not recognize Subsidiary's realized or unrealized capital losses or gains.

Taxpayer's contrary position would result in the disparate tax treatment of variable annuities depending on whether the variable annuities were issued by life or nonlife insurance companies. This unequal tax treatment of variable annuities is contrary to § 817 and Congress' intent as reflected in the DEFRA legislative history.

Accordingly, for the reasons stated above, Taxpayer must apply both § 817(a) and (b) with respect to variable annuities issued by Subsidiary.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call _____ if you have any further questions.